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Nos. 323 - 324

In the Supreme Court of the United States

OCTOBER TERM, 1929

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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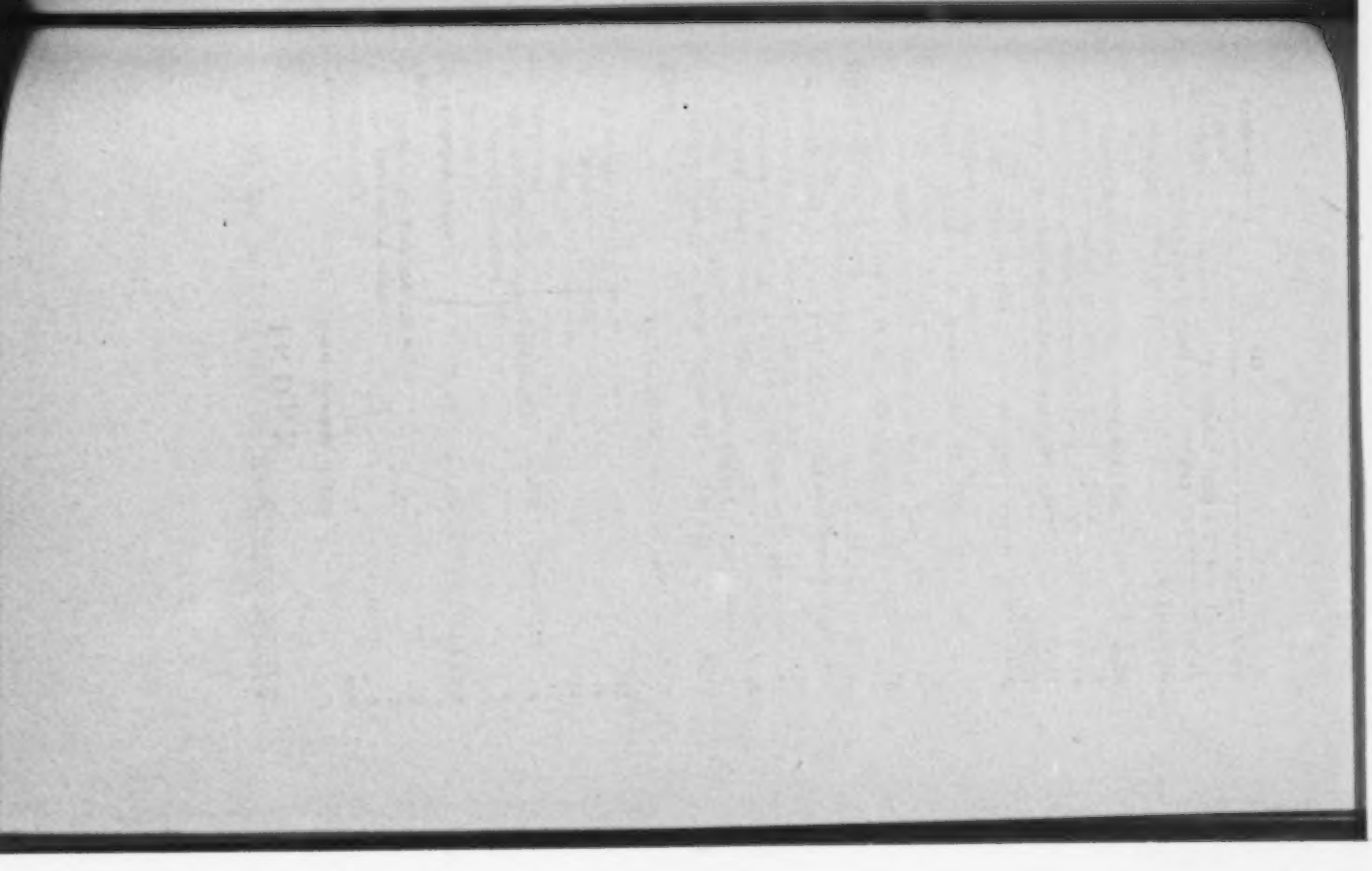

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PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above-entitled cases on May 14, 1929, reversing the decision of the United States Board of Tax Appeals.

STATEMENT

These cases involve income taxes for the years 1918 and 1920. (R. 33.) The taxpayer is a Missouri corporation and was engaged during the years in question in the business of fabricating and erecting structural steel plates for buildings, bridges, tanks, etc. Such business required the use of large quantities of steel bars, tank plates, and structural forms which the company purchased from steel mills. (R. 34–36.)

In order to insure the prompt and orderly execution of contracts, it was the practice of the taxpayer to maintain a considerable stock of material at its plant. (R. 34.) The amount of such stock recorded as being on hand at the end of each year was, roughly speaking, equal to from ¼ to ⅓ of the steel fabricated by the corporation during the entire year. (See tables, R. 35.) The exact quantity varied greatly by reason of the fact that the stock was being continually consumed and replenished in the course of production, in 1912 running as low as 1,500 tons and in 1920 exceeding at one time 11,000 tons. (R. 25, 33.)

As the steel from the reserve supply was used, it was replaced with material of a like kind and in a like quantity. (R. 34.) It does not appear, however, that any account was kept of the particular purchases composing the stock, or that the steel treated as constituting stock was the steel identifiable as to cost or date of acquisition.

In 1916 the price of structural steel was $1.70 per cwt., but beginning in that year the price advanced

until it reached $4.50 per cwt. for structural shapes and $9.45 per cwt. for tank plates. (R. 34.)

The taxpayer, in determining the amount of its taxable income for the years here in question, used inventories to compute the cost of the steel which it had consumed. (R. 34–35.) In such inventory computation, the taxpayer treated 5,554 tons, representing the amount of unfabricated steel held on hand at the close of the year 1916 as a reserve stock which it valued through the taxable years here involved at $1.70 per cwt. (R. 34.) It appears, however, that the total amount of the taxpayer's inventory dropped below the 5,554 tons during each year. All steel in excess of the 5,554 tons was inventoried at cost or market price, whichever was lower. (R. 35.)

The method used by taxpayer as to this 5,554 tons is known to accounting as the "base stock," "minimum," "cushion," or "constant average" method of inventory.

This method was employed by the taxpayer until December 31, 1921, when the price of steel had descended to $1.50 per cwt. The method was then abandoned and the entire inventory was valued by the taxpayer at cost or market, whichever was lower. (R. 34–35.)

The Commissioner of Internal Revenue, in auditing the taxpayer's income tax returns for 1918 and 1920, refused to approve the "base stock" plan which the taxpayer had employed in making its inventories, and to that extent rejected the inventory valuations

which the taxpayer had set up on its books. Since the steel comprising the stock could not be identified with particular invoices, the Commissioner, pursuant to Treasury regulations, computed its cost on the presumption that the supply on hand was that which had been most recently received, pricing the entire inventory at market. (R. 35.) This action resulted in tax deficiencies being determined for the years 1918 and 1920 in the amounts of $7,656.74 and $15,953.36, respectively.

The taxpayer appealed from such determination to the Board of Tax Appeals, but the Board approved the action of the Commissioner. (R. 39.) The taxpayer then filed petitions in the two cases here involved, seeking a review of the Board's decision by the United States Circuit Court of Appeals for the Eighth Circuit, and it was stipulated that the judgment in Case No. 8359 should follow the decision rendered in Case No. 8358.[1] In a decision rendered in the latter case, the Circuit Court of Appeals, by a divided bench, reversed the decision of the Board of Tax Appeals as it affected both cases (R. 49–59), holding that no taxable gains were realized upon 5,554 tons of steel, the amount which taxpayer treated as its reserve stock, and that to include it in inventory distorted rather than reflected the true income of the taxpayer.

[1] Record references given herein are from the record in Case No. 8358, unless otherwise specified.

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

1. In holding that inventories of the taxpayer's reserve stock of steel should not have been used in computing its income for the years in question.

2. In overruling the determination made by the Commissioner, pursuant to discretion vested in him by statute and under regulations of the Treasury Department, that inventories of the reserve stock were necessary properly to determine taxable income.

3. In holding that no taxable gain was realized by the taxpayer upon 5,554 tons of steel, the amount which taxpayer treated as its reserve stock.

REASONS FOR GRANTING THE WRITS

The tax amounts with which these cases are concerned are relatively small, but the principles of tax law involved are of general application and of serious importance to the Government. It is therefore desirable that the decision of the Circuit Court of Appeals be reviewed by this Court. The reasons for granting the writs are:

1. In the case of *Chicago Frog & Switch Co.* v. *United States*, decided by the Court of Claims on June 3, 1929, as yet unreported, it was held that a method of valuing inventories at the same arbitrary price from year to year, which would have the effect of carrying gains or losses of one year into succeeding years, was not sanctioned by the 1917 Act and the regulations thereunder. This principle, we submit, is equally applicable to the taxpayer's practice in the in-

stant case. Also in the case of *American Can Co.* v. *United States*, 31 F. (2d) 730, it was conceded by the taxpayer and assumed by the Circuit Court of Appeals for the Third Circuit that an inventory method quite comparable to the method adopted by the taxpayer herein was not reflective of true income. Petitions for writs of certiorari in that and subsidiary cases are now pending in this Court, but, in view of the above, no controversy is presented therein with respect to this question.

2. The conclusions of the Circuit Court of Appeals regarding the use of inventories which form the basis of the court's decision are not in accord with the best accounting practice. They are specifically in conflict with the principles approved in standard works on income-tax practice and are not sanctioned by recognized authorities on accounting. Montgomery on Income Tax Procedure, 1926 Ed., vol. 1, page 698; Foulke on The Federal Income Tax, Sec. 642.

3. The decision of the Circuit Court of Appeals is directly opposed to long administrative practice and the rules consistently applied by the Internal Revenue Bureau in the collection of revenue over a period of more than ten years. Advisory Tax Board Ruling 65 (see appendix, p. 17). It is also in conflict with regulations promulgated by the Treasury Department for use in connection with the Revenue Act of 1918, and with regulations promulgated for use in connection with the various other Revenue Acts since enacted. Art. 1582, Reg. 45, as amended by

T. D. 3296; Art. 1582, Reg. 62; Art. 1612, Reg. 65; Art. 1612, Reg. 69; Art. 102, Reg. 74.

4. The question involved is of far-reaching importance. Inventories are almost universally used where stocks of raw material are maintained for use in productive processes and they play a necessary part in the administration of the revenue laws. Confusion in administrative practice and discrimination in the treatment of taxpayers is almost certain to result unless the rules with regard to inventories are consistently applied. The matter is one, therefore, which should be settled finally by this Court.

Wherefore, it is respectfully submitted that this petition for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Eighth Circuit should be granted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

AUGUST, 1929.

65400—29——2

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals (R. 49) is reported in 33 F. (2d) 53. The opinion of the Board of Tax Appeals (R. 33) is reported in 11 B. T. A. 877.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered May 14, 1929 (Case No. 8358, R. 59; Case No. 8359, R. 2), upon review of the decision of the Board of Tax Appeals, made pursuant to Sections 1001, 1002, and 1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109–110. (U. S. C. Supp. 1, Title 26, Secs. 1224–1226.) The jurisdiction of this Court to issue the writs is derived from Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Did the Commissioner of Internal Revenue in determining the income of the taxpayer corporation for the years in question properly require the taxpayer to inventory a supply of unfabricated steel denoted as an "emergency supply"?

2. Was the Commissioner correct in rejecting the "constant price" system of inventory valuation used by the taxpayer with respect to this "emergency supply" and in substituting therefor a "market price" valuation?

STATUTES AND REGULATIONS APPLICABLE

The pertinent provisions of the Revenue Act of 1918, c. 18, 40 Stat., 1057, 1060, are as follows:

> SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The pertinent provisions of Treasury Department Regulations 45 (1920 Edition, as amended by T. D. 3296), promulgated under the Revenue Act of 1918, are as follows:

> ART. 1581. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. * * *
>
> ART. 1582. *Valuation of inventories.*—The act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly

reflect the income. * * * In order to clearly reflect income the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is substantially in accord with the regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the revenue act is (a) cost or (b) cost or market, whichever is lower.

* * * * *

* * * Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (a) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (b) where the taxpayer maintains book inventories in accordance with a sound accounting system * * * the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. * * *

* * * The inventories of taxpayers on whatever basis taken will be subject to investigation by the commissioner, and the tax-

payer must satisfy the commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

* * * * *

(d) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

[NOTE.—Art. 1582, *supra*, is in effect a restatement of a Treasury ruling promulgated in June, 1919, as Advisory Tax Board Ruling No. 65, appendix, p. 17.]

STATEMENT

A statement of the facts and an assignment of the errors relied on are set forth in the petition.

ARGUMENT

The substance of the opinion rendered by the Circuit Court of Appeals was that the taxpayer is a contractor; that the steel it used came direct for each job from the mills; that the actual cost of the steel consumed was the same as the cost of the steel ordered; and that the "emergency" stock remained, like its derricks and cranes, useful but unproductive of realized profits until entirely disposed of. Such conclusions can not properly be drawn from the facts found. This taxpayer is not a mere contractor, but a manufacturer who buys raw material in the form of plates and bars and fabricates it into the framework of bridges and buildings. The steel it used did not all come direct from the mills, but a

large part of it came from its own reserve supply. And the cost of such reserve supply steel was not equal to the cost of the steel ordered, for it had been acquired at an earlier date on a considerably lower market. The orders placed at the mills were not merely to take care of the particular job at hand, but also to replenish the reserve supply in preparation for anticipated future contracts.

The facts in this case, we submit, are therefore not unique; they are more or less typical of large numbers of other cases in which manufacturers maintain stocks of raw material for use in their productive processes. The stock here, like most other stocks, was kept in good faith; it was reasonable in amount; and it was necessitated by the remoteness of the more general supply. It was an "emergency" stock only in the sense that it was used to supply the immediate and somewhat temporary demands of the business. It fluctuated in amount from 1,500 tons to 11,000 tons (R. 25, 33). From this fluctuating reserve supply the taxpayer selected a constant of 5,554 tons which it set up on its inventory at a fixed valuation representing market value as of December 31, 1916. Yet so far as the actual content of this reserve stock was concerned it changed in character and varied in value from time to time. We submit that the court was in error in comparing a fluctuating stock of such nature to derricks and cranes, which remain unchanged and unproductive of income until finally disposed of.

The system of inventorying used by the taxpayer of valuing at the same price year after year a constant, so-called minimum quantity of material is not peculiar to this company. It is what is known to accounting practice as the "base stock" method. That method was carefully considered in the Advisory Tax Board Ruling No. 65 (appendix, p. 18) and disapproved as not truly reflecting income. This view was carried into the subsequent Treasury Regulations governing inventories to which later reference is made.

The purpose of the Government in this case, as in all cases where the "base stock" method has been disapproved, is not to tax paper profits but profits actually realized. It proposes to compute the cost of material actually used at its actual cost, and not at the cost of other material which would have been used had circumstances not prevented. The only practicable method of determining the cost of goods consumed from the reserve supply is by use of inventories, for records were not kept of the actual cost of the individual pieces of steel consumed and could not have been kept under any practicable system of accounting. Inventories served simply as a lumping method of determining such cost. By adding the cost of material on hand at the beginning of the year to the cost of material purchased, and then deducting the cost of material on hand at the end of the year, the cost of goods consumed could be determined. This inventory method is now used by the vast majority of business concerns which maintain fluctuating stocks of raw material for productive

use, and it is declared by recognized accountants to be in accord with the best accounting practice. Advisory Tax Board Ruling No. 65, *supra*; Montgomery, Income Tax Procedure, 1926 Ed., vol. 1, page 698; Foulke, The Federal Income Tax, Sec. 642.

Congress, in enacting the various Revenue Acts, recognized the necessity for inventories in the computation of income, and vested a broad discretion in the Commissioner to determine when they should be used. Congress also authorized the Secretary of the Treasury to prescribe rules and regulations regarding the method of making inventories. Pursuant to such authority rules were prepared and they have been published as Treasury Regulations for use in connection with all Revenue Acts since 1918. Art. 1582, Reg. 45, as amended by T. D. 3296; Art. 1582, Reg. 62; Art. 1612, Reg. 65; Art. 1612, Reg. 69; Art. 102, Reg. 74. Regulations so promulgated, if not in conflict with express statutory provisions, have the force and effect of law. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *United States* v. *Grimaud*, 220 U. S. 506. The regulations in regard to inventories have been approved by at least one court of appellate jurisdiction and by the United States Court of Claims. See *United States* v. *Kemp* (C. C. A., 5th), 12 F. (2d) 7, 9, certiorari denied, 273 U. S. 703, and *Chicago Frog & Switch Co.* v. *United States* (C. Cls.), unreported, decided June 3, 1929.

The decision of the Circuit Court of Appeals not only overruled the determinations made by the Commissioner in the exercise of his discretion but it

recognized doctrines and principles which are in direct conflict with the above Treasury Regulations.

Finally, the decision is inconsistent, in principle at least, with what authority there is on this question.

The disapproval by the Court of Claims in *Chicago Frog & Switch Co.* v. *United States, supra*, of an arbitrary method of valuing inventories which would have the effect of carrying gains or losses of one year into succeeding years would seem equally applicable to the taxpayer's practice in the instant case. The taxpayer in that case, because it was compelled to keep a substantial amount of rails on hand at all times, attempted to carry its inventory at a so-called base or standard price, which was the price at the beginning of the year, and it was not asserted that this price was either cost or market for the rails which were on hand at the close of the year. The Commissioner of Internal Revenue adjusted the inventory to market price and his action was approved by the court, which held that the law did not justify the practice of the taxpayer.

The decision here sanctions an inventory method of valuing reserve stock which was quite similar to the "constant inventory" system which was conceded not to be reflective of true income in the case of *American Can Co.* v. *United States*, 31 F. (2d) 730. In that case the taxpayer attempted to increase its opening inventory; here the attempt is to decrease the closing inventory. In each case the taxpayer has failed accurately to reflect the true cost of goods consumed.

CONCLUSION

The decision in the instant case represents a radical departure from long accepted administrative practice and interpretation. It is not of limited application, as the majority opinion suggests, for its facts are in no wise unique but are more or less typical of large numbers of other cases where reserve stocks are used in productive processes. The opinion of the dissenting judge, therefore, rightly apprehends that confusion may flow from the court's conclusions. For these, and other reasons previously urged, it is respectfully submitted that writs of certiorari should be issued.

CHARLES E. HUGHES, Jr.,
Solicitor General.

SEWALL KEY,
RANDOLPH C. SHAW,
Special Assistants to the Attorney General.

AUGUST, 1929.

APPENDIX

Advisory Tax Board Ruling No. 65

29–19–531.
T. B. R. 65.

Section 203, Article 1582: Valuation of inventories.

REVENUE ACTS OF 1917 AND 1918.—The base-stock method of taking inventories is not warranted by the law or the regulations.

The question is raised as to whether under the Revenue Acts of 1917 and 1918 the so-called "base stock," "minimum," or "cushion," hereinafter referred to as "base stock," method of taking inventories may be used.

Section 203 of the Revenue Act of 1918 provides as follows:

> That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Article 1582 of Regulations 45 provides in part that:

> Inventories should be valued at (a) cost, or (b) cost or market, whichever is lower.

According to the base-stock method of taking inventories, a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. If this method is accepted as sound, a second question arises as to the method of determining this price. In the present case the closing inventory for the year 1916 was adopted as the minimum basis for quantity and unit of price, though there was some modification in the following year for new lines of goods.

Clearly the base-stock method of taking inventories is not within the terms of the regulations—that is, it is not such a basis as the Commissioner, with the approval of the Secretary, has prescribed. It remains to consider, however, whether such a method should be so prescribed "as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The facts before the Advisory Tax Board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an "accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of the manufacturers and dealers who have not used it. Returns for 1918 must be made in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, provided this method clearly reflects the income (sec. 212 (b)).

Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a "practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly suggestive of the truth that it does not truly reflect the income.

That it is a truth appears as clearly upon analysis as upon an examination of trade practice. The present Federal income-tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income.

Such profit is not, as suggested by counsel, unrealized appreciation. It is none the less taxable profit because immediately reinvested in inventory. (Moreover, such reinvestment is not an operating expense but, on the contrary, is an expenditure for working assets.) Similarly, loss so realized is none the less deductible loss even though the inventory is not reduced in quantity. In some cases highly conservative business concerns reckon *trading profits* by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains; but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic stock method is a mere counsel of conservatism which ignores quasi-capital gains from motives of prudence. We do not believe that profit from the sale of a basic or minimum inventory is ordinarily a capital gain, but whether it is or not such gains when arising in an annual accounting period by reason of transactions which, taken by themselves, constitute realizations of profit or loss can not be disregarded under American (as distinguished from British) income-tax laws.

To disregard them is to overstate or understate, as the case may be, profits for the annual accounting period. Where the base stock method is used it is true, as was stated in Advisory Tax Board Recommendation 48 with respect to the average cost inventory method that "in a business requiring goods to be carried for lengthy periods * * * this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated." The Advisory Tax Board, therefore, concludes that the base stock inventory method does not "most clearly" reflect income.

For a more complete discussion of the subject of inventories see the Advisory Tax Board recommendation above referred to.

The fundamental theory underlying this method is unsound. While the taxpayer in question happened to adopt 1916 prices in introducing this method of inventorying, the usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. These practices have never been allowed by income tax law and procedure in the case of banks. They can not be allowed in the case of manufacturers. Excessive conservatism in measuring or accounting for capital and income may be nearly as deleterious as the excessive optimism which in the past led some corporations to overstate profits. The latter leads to bankruptcy. The former leads to various evils and brings retributive penalties when occasion arises to measure capital (or "invested capital") for the purposes of rate making, profit, regulation, and the determination of excess-profits taxes.

The base stock inventory is suggested as a method of equalizing gains and losses over a period of abnormal price conditions. In substance it results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the revenue act of 1918 in its provisions with respect to inventory loss and net loss (sections 204, 214 (a) (12), 234 (a) (14), authorizes in some cases the carrying of a loss realized

in one year into accounts of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the medium of these inventory and net loss provisions in cases which are within the terms thereof.

The general importance of this subject makes it worthy of note that a distinguished British commission—the Committee on Financial Risks Attaching to the Holding of Trading Stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1918. (Cd. 9224, 1919.) "Accounting," the committee found in Great Britain, "with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.), misrepresent the facts. In good times large profits are made. If it is desirable to make reserves against the future, part of the profits realized should be set aside as reserves and so denominated. If goods have been bought for £50 and their market price has not fallen below £50 at the time of striking a balance, it is a misuse of language and a travesty of fact to write their value down to £20 out of profits made by selling something else.

"The correct procedure, it is maintained, is to place the difference of £30 to reserve." And again, referring to the fact that the British Board of Inland Revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds: "And it appears that in the absence of a statutory definition the Board of

Inland Revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which Government and the majority of this committee hold as to the correct system of accounting, * * * this concession has not been extended beyond the point of obligation."

The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method.

The general conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918 applies to "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices." According to article 1582 of Regulations 45, such goods "will be deemed to be the goods most recently purchased." The warrant for this presumption or inference is that in the absence of evidence as to the actual fact in the specific case it is, as conceded by counsel for the taxpayer, more nearly true than any other. This presumption or inference is, therefore, not only warranted but required by the statute which in authorizing the Commissioner, with the approval of the Secretary, to prescribe a basis upon which inventories shall be taken requires him to prescribe such basis as "most clearly" reflects the income. Conversely, he can not properly prescribe that "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices" will be deemed to be the goods included in the minimum inventory.

It is suggested in behalf of the taxpayer that if the base-stock method is not approved, some alternative method should be prescribed other than the valuation of inventories as required by the present regulations at cost or market, whichever is lower. One method proposed is that inventories be valued on a moving average basis over a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased, and the balance the goods on hand at the beginning of the year. Another method proposed is that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods are open to the same objections as is the base-stock method. Inventories valued according to these methods would not as clearly reflect the income assignable to an accounting period as do inventories valued according to the present regulations.

Most of the reasoning above set forth with respect to the Revenue Act of 1918 applies to the Revenue Act of 1917. The Advisory Tax Board finds nothing in the earlier statute to warrant the use thereunder of methods of valuing inventories which can not be used under the later statute.

The Advisory Tax Board is of opinion, therefore, that neither the base stock method of taking inventories, nor the moving average method, nor a method based upon the presumption that goods in the inventory are the earliest purchases, is in conformity with the provisions of the Revenue Act of 1917 or of the Revenue Act of 1918, and recommends that no change be made in the present regulations with respect to the method of taking inventories.

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